Only fools rush into short selling

Pauline Skypala
COMMENT

-The practice of selling shares short in expectation of a price fall has come under suspicion in recent weeks. Some investors, it is suggested, have started vicious rumours about a company whose shares they have sold short in order to drive down the share price and reap big profits.

The attempt on HBOS, one of the UK's biggest banks, earlier this month stung the Financial Services Authority, the UK regulator, into announcing an investigation into potential market manipulation. HBOS shares fell 17 per cent in early trading on March 19 amid speculation that it had sought emergency funding from the Bank of England.

Sally Dewar, managing director, wholesale and institutional markets at the FSA, said: "We will not tolerate market participants taking advantage of the current market conditions to commit abuse by spreading false rumours and dealing on the back of them." The Securities and Exchange Commission in the US also reminded market participants of the repercussions of manipulating markets following the collapse of Bear Stearns.

Last week, the UK chancellor, Alistair Darling, said he would give the FSA new US-style plea-bargaining powers to clamp down on market manipulation.

Some commentators have questioned why the authorities are taking a tougher line on market manipulation that involves trashing companies to push down their share price than on the practice of ramping shares to drive prices up. There was plenty of that going on in the dotcom boom at the turn of the century.

The FSA in fact issued several warnings in 1999 and 2000 to investors of the dangers of share ramping via internet chat rooms. It said share trading firms should monitor chat rooms "for unauthorised investment advice, or share ramping through suggestions or gossip".

But it was not until mid-2001 that the Financial Services and Markets Act subjected all market players to the same regime for dealing with market abuse.

It could also be argued that ramping may result in losses to investors but does not threaten financial stability. Putting a big bank at risk through the circulation of false rumours is a different game altogether. There are some concerns that the HBOS experience could lead to restraints on short selling, just as it is becoming accepted as a mainstream investment technique. Shorting has always had critics and still scares many investors, but the rise of 130/30 funds, which go 30 per cent short and 130 per cent long and are offered by well-known fund management houses, has put shorting on the map for an increasing number of institutional investors.

The increasing use of the flexibility allowed under Ucits III regulations has also seen more managers making use of both shorting and gearing in some funds.

Simon Fraser, president of institutional business at Fidelity International, says short selling, like other investment techniques, can be dangerous if used improperly, but is a useful tool if correctly employed.

"It is being more widely used so we need to ensure there are the right rules and regulations around it," he says. He suggests additional transparency would help police the use of shorting, but does not expect the shock of the HBOS experience will lead regulators to curtail its use in regulated funds.

Short selling makes markets more efficient, he maintains, a view widely shared by academics. But in the current market turmoil "maybe it is being abused, and we need to make sure it is stamped out".

He does not believe all fund managers should be free to short sell. It requires different skills than traditional long-only investing. "You need to understand timing, volatility and the cost of borrowing stock. The risks are definitely greater, so you shouldn't make it available to all managers."

At Fidelity, shorting is only allowed in products deliberately designed to be higher risk, and targeted at sophisticated investors. The experience so far is that the higher risk has been converted to higher return, says Mr Fraser.

Fidelity is probably regarded as a conservative fund house. It does not rush into hot investment areas, and has been cautious with new investment tools. That must be the right way to proceed. Make sure you know what you are doing should be the cardinal rule for all players in financial markets.

Simon Fraser discusses the issue of short selling in FTfm's regular video interview at www.ft.com/ftvideo

Pauline Skypala is the editor of FTfm

Sally Dewar: 'We will not tolerate market participants . . . committing abuse'
Charlie Bibby

How to be moral at the edge of legality

Talking Head
YANNICK MALEVERGNE and DIDIER SORNETTE

The market economy and capitalism are the modern expression of the freedom to create, innovate, produce and trade. However, even if the notions of morality and ethics are historically irrelevant to the capitalist doctrine, we have to grant that moral behaviours should be encouraged in order for capitalism to work efficiently.

The unfolding subprime crisis and the subsequent credit crunch clearly illustrate this point, exemplifying a deeper moral crisis, characterised by individual and collective losses of a sense of responsibility. Subprime loan sellers were enticed through their compensation structure to turn a blind eye to the credit-worthiness of their clients; by securitising these loans in the financial markets, banks obtained fees plus a comforting sense of safety; investors sought new investment vehicles providing both high yields and an illusion of diversification.

The present crisis is essentially similar to previous financial turmoil, sharing three fundamental ingredients.

First, from executives to salesmen, incentive mechanisms promote a generalised climate of moral hazard. Incentives have a perverse effect: they encourage decision makers to favour strategies that lead to short-term irreversible profits for them at the expense of medium and long-term risks for their firm and their shareholders. It is often the case that firms end up losing significantly more – when the risks unravel – than their previous cumulative gains based on these risky positions, while managers responsible for this situation keep their fat bonuses. As long as the risks are borne by the firm and not equally by the decision-makers, the ensuing moral hazard will not disappear.

Second, herding effects amplify moral hazard. Indeed, performance is commonly assessed on the basis of comparisons with the average industry performance. Therefore, a manager cannot afford to neglect high-yield investment opportunities favoured by competitors, even if he or she believes that, in the long run, they could turn out badly. Besides, herding is often rationalised by the introduction of new concepts, such as "the new economy" during the internet bubble. Eventually, herding provides a sense of safety in numbers: how could everybody be so wrong?

> We must collectively address the central problem of asymmetric incentives leading to moral hazard, aided by herding and the myopic focus on returns

Third, while the circumstances that catalyse each particular crisis are specific, they contribute generically to focus the investors' attention on the high level of expected return, making them forget that returns should just be fair compensation for systematic risks. Concerning the subprime crisis, it is hard to believe that the major institutional investors were not aware that subprime residential mortgage-backed securities were rotten, even if the sheer complexity of these investment vehicles may have played a role in lulling them.

The intrinsic nature of these three elements and the strong positive feedbacks between them suggest that financial crises are bound to repeat and worsen, as world integration increases and financial complexity blossoms.

Is there a remedy?

The ingrained reaction to a crisis is to update and upscale regulations and supervision. This is a necessary step to restore investors' confidence over the short term but has repeatedly failed to ensure even medium-term stability in the past. The reason is simple and rational: it is the essence of entrepreneurial businesses to innovate and exploit all potential initiatives allowed within the law, that is, to function at the borders of legality. Reinforcing legislation would probably be counter-productive in the long run and even create market frictions, making financing operations more costly.

Some have proposed to mitigate moral hazard, for instance, by devising deferred compensation funds that would reward multi-period performance to make managers accountable for maximising the long-run profits of their companies. However, deferred compensation comes up against the problem of defining what is meant by "long run".

Should therefore compensations and bonuses be even more delayed than existing option-like compensation plans? How would this feed back on the risk appetite of bankers and investment houses, and finally on the overall level of liquidity and diversification provided by the financial universe?

Another concept, inspired by recent advances in neuro-economics, is to design mechanisms by which trust and co-operation is encouraged, so that "immoral" behaviour is repressed by the cultural norm. For instance, a trust system selecting preferred sellers and buyers based on their past behaviour has been successfully implemented by market makers trading small cap firms.

How could this be implemented on a large scale and how could it be resilient to various flaws and frauds? In short, how do we prevent the actors from gaming the rules?

These are hard questions that should be put at the centre of the debate if the financial system is to deliver its expected benefits to society. There is absolutely no doubt that other extreme crises will re-occur if we do not collectively address the central problem of asymmetric incentives leading to moral hazard, aided by herding and the myopic focus on returns.

Yannick Malevergne is professor of finance at the Institute of Business Administration, University of Saint-Etienne and at the EM Lyon Business School

Didier Sornette is professor of finance on the chair of entrepreneurial risks at the Swiss Federal Institute of Technology and member of the Swiss Finance Institute